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MASSACHUSETTS FINANCIAL SERVICES

BEFORE THE

SUBCOMMITTEE ON FINANCE AND HAZARDOUS MATERIALS

COMMITTEE ON COMMERCE

U.S. HOUSE OF REPRESENTATIVES

ON

FINANCIAL SERVICES REFORM

MAY 1, 1997

ARNOLD D. SCOTT
SUMMARY OF TESTIMONY ON FINANCIAL SERVICES REFORM

- Massachusetts Financial Services ("MFS") endorses five principles for financial services reform. Congress should grant banks full mutual fund powers; modernize the federal securities laws to address bank mutual fund activities; permit the affiliation of banks, securities firms, insurance companies and commercial entities; provide for functional regulation of each of these entities; and create an appropriate oversight system for the resulting diversified financial services organization.

I. All three bills presently before the House Banking Committee properly recognize that insurance activities are inherently financial in nature, and that insurance providers and products should be part of any new structure Congress creates for the financial services industry. A number of mutual fund companies are affiliated with insurance organizations that are involved to some degree in real estate or other commercial activities. In order to bring these mutual fund companies and other similarly situated firms under the statutory tent, Congress should ensure that any financial services reform legislation ultimately enacted permits financial firms to have some part of their business involved in nonfinancial activities.

I. MFS believes that the optimal oversight system for the new diversified financial services organization is one based on functional regulation, bank centered supervision and enforcement and enhanced regulatory coordination. An oversight system based upon these principles most appropriately protects the public interest while minimizing the potential for distortion of the marketplace by providing the regulatory framework needed to address potential risks while imposing the fewest restrictions on the new organization's ability to satisfy consumer demand for new and innovative services.

I. Congress should resist the calls to impose consolidated bank holding company supervision on the new organization. Consolidated supervision carries with it a number of likely adverse consequences, including

the creation of inefficiencies in and potential interference with the competitiveness of non-bank operations. Proponents have not shown that adoption of this system, with its accompanying baggage, is necessary in order to protect banks or the banking system.

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I. Introduction

My name is Arnold D. Scott. I am Senior Executive Vice- President, a member of the Board of Directors and a member of the Executive Committee of Massachusetts Financial Services ("MFS"), America's oldest mutual fund organization. MFS and its predecessor organizations have a history of money management dating from 1924 and the founding of the first mutual fund in the United States, Massachusetts Investors Trust. MFS presently serves as investment advisor to over 100 mutual funds and MFS and its wholly owned subsidiary, MFS Institutional Advisors, Inc., also provide investment advice to private clients. As of December 31, 1996, net assets under the management of the MFS organization were approximately $52.1 billion on behalf of over 2.2 million investor accounts.

MFS is a subsidiary of Sun Life Assurance Company of Canada (U.S.) ("Sun Life of Canada"), which in turn is a wholly owned subsidiary of Sun Life Assurance Company of Canada ("Sun Life"). Both Sun Life of Canada and Sun Life are unitary savings and loan holding companies by virtue of Sun Life of Canada's direct ownership of New London Trust, F.S.B., a federally chartered thrift.

I welcome and appreciate the opportunity to appear before you today as you consider the subject of financial services reform. The mutual fund industry previously has set forth five principles for financial services reform with which we wholeheartedly concur and which warrant repeating here today.

I. Congress should grant banks full mutual fund powers (*e.g.* the ability to sponsor and underwrite mutual funds and to have bankers serve on fund boards);

a)

II. Congress should modernize the federal securities laws to address bank-mutual fund activities;

a)

III. Congress should permit banks, securities firms, insurance companies and commercial entities to own and affiliate with each other;

a)

IV. Congress should provide for functional regulation of each entity (bank, securities firm, insurance company, etc.) within the resulting diversified organization; and

a)

V. Congress should create an oversight system governing organizations owning both securities firms and banks that maximizes the public interest in protecting consumers of financial services while minimizing the potential for distortion of the marketplace through unnecessary, duplicative, artificial, or overly rigid regulatory requirements.[1]

The House Banking Committee presently has before it three bills which, if enacted, would usher in a new world of diversified financial services organizations -- i.e., holding companies that would have the power to own securities firms, insurance companies and banks under a single roof. These bills are H.R. 10, introduced by Chairman Leach, H.R. 268, introduced by Congresswoman Roukema, and H.R. 669, introduced by Congressman Baker. Although only one of these bills (H.R. 669) would tear down the existing walls separating banking from commerce, all of them are significantly better than many past financial services reform bills from the perspective of permissible affiliations among businesses. Specifically, all three of the bills recognize that insurance activities are inherently financial in nature, and that economic reality, consumer convenience and competitive equity require that insurance providers and products be part of any new structure Congress creates for the financial services industry. This development is particularly important for an organization like MFS, whose ultimate parent derives 90% of its consolidated revenue from insurance activities.

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[1] *See, e.g, written statement of Matthew P. Fink, President, Investment Company Institute, On H.R. 268 Before the Subcommittee on Financial Institutions And Consumer Credit of the House Committee on Banking And Financial Services* at 1-2 (Feb. 11, 1997)("February 1997 Fink Statement").

Merely recognizing that insurance is financial, however, is not enough to bring all financial firms under the tent. For example, a number of mutual fund companies are affiliated with insurance companies that are involved to some degree in real estate or other commercial activities. Congress should ensure that any reform legislation contains a statutory provision permitting financial firms to have some part of their business involved in nonfinancial activities in order to permit these mutual fund companies and other similarly situated firms to participate fully in the financial services industry. Congress also should decide for itself the scope and amount of permissible nonfinancial activities and should embody its determinations clearly in the statutory text. The judgments involved are legislative, not administrative, in character and too important to leave to the discretion of future banking or other regulators.

Although the issue of permissible business affiliations is important, my testimony today will focus upon an even more critical aspect of financial services reform -- the characteristics of the oversight system that should govern the new diversified financial services organizations. MFS believes that this oversight system should be based on functional regulation, bank centered supervision and enforcement and enhanced regulatory coordination. An oversight system based upon these principles most appropriately protects the public interest while minimizing the potential for distortion of the marketplace, functional regulation would provide the necessary framework for addressing any potential risks that may flow from the creation of the new diversified organization while imposing the fewest restrictions on the organization's ability to satisfy consumer demand for new and innovative services.

Congress should resist the calls for consolidated bank holding company supervision. Although this oversight system has governed some companies owning commercial banks since the mid-1950s and almost all companies owning commercial banks since 1970, the companies presently regulated under this system are different from the new organizations under contemplation. The regulated companies historically have been bank holding companies owning solely banks and companies engaged in activities closely related to banking, and not diversified financial services organizations owning a wide range of non-banking companies as well as commercial banks. Imposing consolidated bank holding company supervision on these new organizations will create inefficiencies in and potentially interfere with the competitiveness of their non-bank operations. Proponents of consolidated supervision have not shown that it is

necessary to accept these adverse consequences in order to protect particular banks in individual holding company complexes or to safeguard the banking system in general.

II. Optimal Diversified Financial Services Organization Oversight

The optimal oversight system for the new diversified financial services organization is one centered on functional regulation, bank centered supervision and enforcement and enhanced regulatory coordination.

The term "functional regulation" refers to a system under which each subsidiary of the new holding company is regulated by function. For example, the Securities and Exchange Commission ("SEC") would act as the primary regulator of securities firms and the appropriate federal banking regulator would act as the primary regulator of depository institutions.

Functional regulation provides a solid foundation for the new oversight system because it builds upon existing regulatory mechanisms that serve the public interest well. For example, securities firms in general and participants in the investment company marketplace in particular already are subject to extensive regulation and supervision by the SEC under the federal securities laws. As the Commerce Committee is well aware, Congress only recently examined the statutory and regulatory scheme governing the investment company industry and concluded that the system was functioning well. The success of the existing oversight system is also demonstrated by the renowned strength, depth and liquidity of the U.S. capital markets, including the mutual fund industry.

The term "bank centered supervision and enforcement" refers to a system under which statutory or regulatory obligations, restrictions or prohibitions deemed necessary in order to protect the safety and soundness of banks within the holding company would be imposed directly on those banks, rather than on other entities affiliated with the banks. Likewise, administrative efforts to monitor and enforce compliance with these obligations, restrictions and prohibitions would be channeled into examinations and enforcement

proceedings directed against the banks, rather than into examinations and enforcement proceedings directed against entities affiliated with the banks.

Bank centered supervision and enforcement makes sense because it focuses attention on the entity -- the bank -- that the oversight system is seeking to protect. It is indirect and inefficient to try to protect one institution by regulating others. Resistance to protecting banks through bank regulation seems to imply concern with the content or administration of the existing regulatory system governing banks. These kinds of concerns should be dealt with directly, rather than by imposing layers of bureaucracy and regulatory burden on the holding company or its non-bank subsidiaries.

The term "enhanced regulatory coordination" refers to a process in which the functional regulators of the various subsidiaries of the holding company would cooperate with each other in carrying out their regulatory responsibilities. At a minimum, this process would call for the adoption of mechanisms for sharing information and coordinating enforcement activity. It also would imply harmonization of reporting requirements and enforcement jurisdiction.

Enhanced regulatory coordination facilitates efficient oversight by maximizing the resources and expertise of all functional regulators. At the same time, it reduces the potential for subjecting regulated entities to duplicative or potentially inconsistent regulatory requirements, and for distorting the marketplace through unneeded, artificial or overly rigid governmental intervention.

III. Consolidated Bank Holding Company Supervision

All three of the bills presently before the House embody to some degree the consolidated bank holding

company system of oversight. This system seeks to protect banks in a holding company complex by appointing the Federal Reserve Board (or some other agency) to act as a superregulator of the holding company and its component firms. The influence of this system is most visible in H.R. 10, which would grant the Federal Reserve Board express authority to regulate the new holding company and its non-bank subsidiaries virtually from cradle to grave. The influence of the system is much less marked in H.R. 268 and H.R. 669, although there are provisions in these bills as well that need refinement or revision to confine banking agency authority to banks and to ensure that the role of the new National Financial Services Committee is limited to that of a coordinating and advisory body.

As the SEC has recognized, consolidated bank holding company supervision is inappropriate for a diversified financial services organization owning both bank and a wide range of non-bank subsidiaries.[2] Consolidated supervision often requires regulated entities to give notice and seek regulatory approval before engaging in new activities. These obligations interfere with the ability of entrepreneurs in financial firms affiliated with banks to respond quickly to developments in the marketplace with new products.

Consolidated bank holding company supervision also subjects regulated entities to duplicative and potentially conflicting regulatory requirements. For example, consolidated supervision could result in a securities firm affiliated with a bank becoming subject to Federal Reserve Board capital, reporting, examination or enforcement requirements in addition to those imposed by self-regulatory organizations or the SEC. Financial firms unaffiliated with banks, however, would be free to compete without carrying this extra weight.

Consolidated bank holding company supervision will also almost certainly lead to the imposition of safety and

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[2] *See, e.g., Hearings before the House Committee on Banking and Financial Services on H.R. 1062, The Financial Services Competitiveness Act of 1995, Glass-Steagall Reform and Related Issues (Revised H.R. 18), Part 2*, 104th Cong., 1st Sess. 67-68 (Mar. 7, 1995)("March 1995 Hearings") (testimony of SEC Chairman Levitt).

soundness regulation on the holding company or its non-bank subsidiaries in order to protect affiliated banks. Both prior experience and the statements of banking regulators in the United States provide domestic confirmation of this statement,[3] and MFS has had first hand experience with this phenomenon in Europe and other parts of the world.

This type of banking-based regulation is fundamentally at odds with the nature of the securities markets in this country and with the regulatory scheme embodied in the federal securities laws. The securities markets are based upon risk taking, not risk avoidance, and the securities laws protect investors by requiring that risk taking be disclosed instead of managed by a federal bureaucracy. Consolidated supervision also is unwarranted since it may lead the market to believe that the federal safety net will be extended to protect the holding company and its non-bank subsidiaries.

Observers and participants urging consolidated bank holding company supervision do not dispute any of these points. Instead, they assert that consolidated supervision should be adopted in spite of these market inefficiencies and competitive distortions in order to further banking objectives. Proponents have not shown that it is necessary for Congress or the economy to accept the adverse consequences described above, however, either to protect particular banks in individual holding company complexes or to safeguard the banking system in general.

For example, it has been argued that full consolidated bank holding supervision is necessary to enable the Federal Reserve Board to stabilize the economy, to conduct monetary policy and to ensure the safe operation of the nation's payment and settlement systems. But, the Federal Reserve Board conducts all of these activities primarily through banks.[4] As a result, it is far from clear why the Board's responsibilities require more than adequate authority over participating banks. Certainly, to the extent that the Board needs information about or power over non-bank

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[3] *February 1997 Fink Statement* at A-1, A-2.

[4] *See, e.g.,* Board of Governors of the Federal Reserve System, *The Federal Reserve System, Purposes & Functions*, at 33-59 (1994); Federal Reserve System Staff Study, *Clearance and Settlement in U.S. Securities Markets* at 4, 17-18 (Mar. 1992); Junker, Summers and Young, *A Primer on the Settlement of Payments in the United States,* 77 Fed. Res. Bull. 847, 847-850, 854-857 (Nov. 1991).

participants such as clearinghouses, depositories or others, proponents have failed to articulate at all the nature of the authority the Board needs or the reasons it needs that authority.

It has also been suggested that consolidated holding company supervision is simply a cost that must be paid for the subsidy that comes with owning a federally insured bank. Many respected banking regulators, however, have expressed doubt as to whether any such subsidy exists. And, even if it does, there has been no showing that consolidated supervision is necessary to deal with any resulting risks to individual holding companies owning banks or to the banking system more broadly. Indeed, it is telling in this regard that the Federal Reserve Board today is in the process of "sharply reduc[ing]" consolidated supervision of *all* existing bank holding companies, and believes that the "case is weak" for any consolidated supervision of any holding company in which the bank "is not the dominant unit" and is not large enough to induce systemic problems should it fail.[5]

It also has been asserted that consolidated supervision is necessary in order to provide the Federal Reserve Board with "information," "intelligence," "knowledge" and "expertise" about the activities and financial condition of banks that are not otherwise subject to the primary jurisdiction of the Board and of non-banking members of the holding company complex. The Board needs this data, it is said, in order for the Board, its examiners and economists to stay abreast of developments in the industry; to understand the impact of the Board's macroeconomic policies and activities; to learn about the consolidated risk management techniques used by some members of the financial services industry; and to monitor the possibility of contagion effects in a holding company structure, where difficulties in a non-banking subsidiary might spread to a well-capitalized bank affiliate.

It again is far from apparent why these considerations justify the imposition of consolidated supervision. If the Board needs additional information from or about banks that are subject to the primary jurisdiction of other bank

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[5] *Statement by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises of the Committee on Banking and Financial Services, U.S. House of Representatives* at 11, 12 (Mar. 19, 1997) ("March 1997 Greenspan Statement").

regulators, it is difficult to understand why the direct solution is not for the Board to obtain copies of the needed information from these other bank regulators. Similarly, to the extent the Board has a legitimate need for information about the risks posed by the activities of a holding company or its non-bank subsidiaries to an affiliated bank, holding company risk assessment mechanisms appear to present a much more cost-effective solution than consolidated supervision.

Holding company risk assessment mechanisms would permit the functional regulator for a bank owned by a diversified organization to obtain information about the holding company or its non-bank subsidiaries from the bank itself or from the functional regulator of the holding company or the non-bank subsidiaries. Section 109 of H.R. 268, for example, contains precisely these types of mechanisms. The mechanisms in H.R. 268 are very similar to, and indeed are based on, the risk assessment provisions of the Market Reform Act of 1990 and of the Futures Trading Practices Act of 1992. Under the Market Reform Act, the SEC monitors risks to broker-dealers from affiliate activities, while the CFTC assesses risks to futures commission merchants from affiliate activities under the Futures Trading Practices Act.

The SEC has found the risk assessment provisions of the Market Reform Act to provide a "significant complement" to its existing statutory authority.[6] The CFTC has not expressed any dissatisfaction with the reach or operation of the risk assessment provisions it administers. This experience suggests that holding company risk assessment procedures would provide valuable tools for monitoring individual and systemic risk in the context of diversified financial services organizations. Certainly, banking regulators and other observers to date have not explained why holding company risk assessment mechanisms, with or without appropriate modifications, are not up to the job.

Proponents of consolidated supervision simply have not justified why the system should be adopted, especially when the system has the potential to impair the free flow of competition. As former FDIC Chairman William Isaac put it:

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[6] *March 1995 Hearings* at 274 n.30 (written statement of SEC Chairman Levitt).

> Perhaps a case can be made for umbrella supervision, but it hasn't been done yet. We will need a great deal more information about precisely what problems the umbrella supervisor will be expected to address. We will also need a much clearer delineation of what authority the umbrella supervisor will have.[7]

IV. Conclusion

It is critically important that Congress adopt an oversight system that maximizes the benefits of the new diversified financial services organization while at the same time providing the necessary framework for addressing potential risk. An oversight system grounded in functional regulation, bank centered supervision and enforcement and enhanced regulatory coordination carries great promise for achieving this goal. Consolidated supervision, in contrast, does not. It is likely to impede the realization of these benefits while, in the words of SEC Chairman Levitt, "stifl[ing] the kind of entrepreneurship" which is "a terribly important part of what [the securities industry] does and what it should continue to do."[8]

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[7] American Banker, *Greenspan Hasn't Made Good Case For Bank Regulation Czar*, April 10, 1997 at p. 9.

[8] *March 1995 Hearings at* 67-68 (Mar. 7, 1995) (testimony of SEC Chairman Levitt).

ORAL STATEMENT OF ARNOLD D. SCOTT

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My name is Arnold D. Scott, Senior Executive Vice-President of Massachusetts Financial Services, America's oldest mutual fund organization.

MFS endorses the five principles for regulatory reform previously set forth by the mutual fund industry. These principles are that Congress should grant banks full mutual fund powers; modernize the federal securities laws to address bank mutual fund activities; permit the affiliation of banks, securities firms, insurance companies and commercial entities; provide for functional regulation of each of these entities; and create an appropriate oversight system for the resulting diversified financial services organizations.

Congress should ensure that any reform legislation ultimately enacted permits financial firms to have some part of their business involved in nonfinancial activities. Congress also should decide for itself the scope and amount of permissible nonfinancial activities and should embody its determinations clearly in statute.

My testimony today focuses on the characteristics of the oversight system that should govern the new diversified financial services organizations. MFS believes that the optimal oversight system is one based on functional regulation, bank centered supervision and enforcement and enhanced regulatory coordination.

An oversight system based upon these principles most appropriately protects the public interest while minimizing the potential for distortion of the marketplace. The system would provide the regulatory framework needed to address potential risks while imposing the fewest restrictions on the new organizations' ability to satisfy consumer demand for new and innovative services.

Congress should resist the calls to impose consolidated bank holding company supervision on the new organizations. Imposing consolidated supervision on the new organizations will create inefficiencies in and

potentially interfere with the competitiveness of their non-bank operations. It will also interfere with the current system of securities regulation.

Proponents of consolidated bank supervision have not shown that adoption of this system, with all of its baggage, is necessary in order to protect banks or the banking system. Making sure that the Federal Reserve System has adequate authority over banks would appear to address many of the concerns proponents have identified. Enactment of risk assessment mechanisms that would provide the Federal Reserve with information about the activities of the holding company and its non-bank subsidiaries would appear to address the remainder. Similar risk assessment systems presently are being employed successfully in both the securities and commodities industries.

In sum, any new oversight system should be grounded in functional regulation, bank centered supervision and enforcement and enhanced regulatory coordination. Such fundamental reforms carry the greatest promise for realizing the benefits that have led Congress to consider financial modernization in the first place. Congress should not impose bank-type regulation on the new diversified holding companies or their non-bank subsidiaries.

I appreciate the opportunity to appear before you today to discuss these subjects and would be happy to answer any questions you may have.

ARNOLD D. SCOTT

Arnold D. Scott is Senior Executive Vice President, a member of the Board of Directors and a member of the Executive Committee of Massachusetts Financial Services (MFS), America's oldest mutual fund organization. He is also a Director of MFS International, Ltd., MFS' international operating subsidiary and serves as a Director of all of MFS' domestic subsidiaries as well.

Mr. Scott joined MFS in 1969 and was named Assistant Secretary in 1970; Secretary in 1973; General Counsel in 1976; Senior Vice President and General Counsel in 1979; Executive Vice President and General Counsel in 1982; Senior Executive Vice President in 1985; and a Director and a member of the Executive Committee in 1988. In April, 1997, he became the first Director of Strategic Planning at MFS.

In 1993 he was elected a Trustee of Massachusetts Investors Trust, America's first mutual fund. Currently he serves as a Trustee of all registered investment company clients of MFS. He also is a Director of the MFS Meridian Funds and the MFS International Funds, respectively Cayman Island and Luxembourg based fund clients of MFS.

He is a graduate of Alderson-Broaddus College and Rutgers University School of Law. Mr. Scott is a member of the Board of Governors and the Executive Committee of the Investment Company Institute, the trade association of the American mutual fund industry.

April 1997